

Internal Revenue Service

memorandum

CC:TL-N-560-91

Br4:GBFleming

date: **JAN 15 1991**

to: [REDACTED], Special Trial Attorney SE: [REDACTED]

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [REDACTED]

This responds to your memorandum of October 16, 1990, requesting our views concerning the stipulation of facts in the above captioned case with respect to the petitioner's recovery of [REDACTED] using the [REDACTED] process. Because your request raises the fundamental question of whether the [REDACTED] recovery process constitutes a [REDACTED] process under I.R.C. § [REDACTED](c)(4), we have requested the views of the Assistant Chief Counsel (Passthroughs and Special Industries) (CC:P&SI) concerning that issue and have attached a copy of CC:P&SI's memorandum.

ISSUES

1. Whether the [REDACTED] recovery process used to recover elemental [REDACTED] from [REDACTED] is a [REDACTED] process within the meaning of I.R.C. § [REDACTED](c)(4).
2. Whether it would be inconsistent with respondent's position in this case to stipulate that the petitioner's separation processes are production processes for purposes of I.R.C. § [REDACTED].

CONCLUSIONS

1. To the extent, if any, that percentage depletion is allowable under I.R.C. § [REDACTED] for [REDACTED] obtained from [REDACTED], the [REDACTED] process does not constitute a [REDACTED] process within the meaning of I.R.C. § [REDACTED](c)(4).
2. Although the Service will continue to maintain its primary position that [REDACTED] obtained from [REDACTED] is not separately depletable, we do not believe that Service position would be prejudiced in this case by stipulating that certain separation processes are production processes.

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DISCUSSION

Issue 1. The [REDACTED] Process

As discussed in the attached memorandum from CC:P&SI, the Service's technical position is that the [REDACTED] recovery process is not a [REDACTED] process within the meaning of I.R.C. § [REDACTED](c)(4) and Treas. Reg. § 1. [REDACTED]-4(f). The principal bases cited by CC:P&SI for this conclusion are:

- (1) The [REDACTED] process is not a named [REDACTED] process identified in I.R.C. § [REDACTED](c)(4)(D) or Treas. Reg. § 1. [REDACTED]-4(f)(5) and does not correspond to any process described in Rev. Proc. 78-19, 1978-2 C.B. 491.
- (2) The [REDACTED] process reduces the chemical compound [REDACTED] to elemental [REDACTED] and thus constitutes a treatment effecting a chemical change within the meaning of I.R.C. § [REDACTED](c)(5) (*see also* Treas. Reg. § 1. [REDACTED]-4(g)(6)(vii)) and is analogous to the heating process described in Rev. Rul. 72-473, 1972-1 C.B. 284, for producing elemental phosphate from phosphate concentrate.
- (3) Because it involves the use of temperatures of approximately [REDACTED], the [REDACTED] process is a thermal action within the meaning of I.R.C. § [REDACTED](c)(5) (*see also* Treas. Reg. § 1. [REDACTED]-4(g)(6)(viii)).
- (4) While I.R.C. § [REDACTED](c)(4)(B) explicitly provides that specified activities in the recovery of [REDACTED] by the [REDACTED] process are [REDACTED] processes, Congress did not expressly provide for treating the [REDACTED] method or any other method of recovering [REDACTED] as a [REDACTED] process even though such methods were being used to recover [REDACTED] from [REDACTED] [REDACTED] when I.R.C. § [REDACTED](c) was enacted.

While CC:P&SI's memorandum provides a technical framework for litigating this issue, CC:P&SI points out that the Service's principal position is that the allowability of percentage depletion for [REDACTED] from [REDACTED] is governed by I.R.C. § [REDACTED] A rather than I.R.C. § 613. Although the Tax Court rejected this position in [REDACTED], we disagree with the holding in [REDACTED] and intend to recommend an appeal of that opinion when the Tax Court enters a final decision. While the Service is effectively foreclosed from relitigating the principal Service position in this case, CC:P&SI is concerned that litigating whether the [REDACTED] recovery process is a [REDACTED] process under I.R.C. § [REDACTED] may preclude an effective appeal in [REDACTED]. In our view, litigating the [REDACTED] process issue in this case should not undermine an ultimate appeal of the issue presented in [REDACTED].

In addition, CC:P&SI strongly believes that the expert assistance of a [REDACTED] engineer familiar with the [REDACTED] processes named in I.R.C. § [REDACTED](c) and a chemical engineer knowledgeable about the chemical change effected by the [REDACTED] process is

essential in order for the Service to prevail in this case. Moreover, since the implementation of the [REDACTED] process may vary, the specific facts regarding the petitioner's operations will have to be documented.

Issue 2. Stipulation Concerning Separation Processes

Your memorandum states that petitioner has proposed to stipulate that its separation, [REDACTED] stabilization and absorption processes are production processes for purposes of calculating percentage depletion. As discussed in your supplemental memorandum of November 8, 1990, prior to the enactment of I.R.C. § [REDACTED] A, the Service, as a matter of administrative practice, allowed taxpayers to include in gross income from an [REDACTED] property under I.R.C. § [REDACTED] (a) the income, reduced by manufacturing costs, from the sale of [REDACTED] recovered from the [REDACTED]. Under this practice, the taxpayer received the same percentage depletion rate for [REDACTED] as for [REDACTED].

Since the enactment of I.R.C. §§ [REDACTED] (d) and [REDACTED] A in [REDACTED], the Service has continued the administrative practice of treating [REDACTED] recovered from an [REDACTED] in the same manner as [REDACTED] for percentage depletion purposes. Because of the restrictions imposed by I.R.C. §§ [REDACTED] (d) and [REDACTED] A, however, the result of this practice is to allow percentage depletion on the [REDACTED] recovered from the [REDACTED] only to the extent the taxpayer qualifies for percentage depletion for [REDACTED] under I.R.C. § [REDACTED] A. As we argued in [REDACTED], we believe that the expansive definition of "[REDACTED]" in I.R.C. § [REDACTED] A(e)(2) justifies the Service's position.

As pointed out in your October 16 memorandum, Technical Advice Memorandum 7908005 (September 6, 1978) determined that the separation of [REDACTED] from [REDACTED] is a production process for purposes of percentage depletion. Accordingly, the TAM concluded that the costs of the absorption process employed to effect the separation should not be deducted from the revenues received from sale of the [REDACTED] for purposes of calculating the percentage depletion allowance for [REDACTED].

The conclusion in TAM 7908005 is consistent with Prop. Reg. § 1. [REDACTED]-3(b)(2), 33 Fed. Reg. [REDACTED] ([REDACTED]) (copy attached), which provided that the separation of [REDACTED] from extracted [REDACTED] is a production process for purposes of percentage depletion. Although that regulation was subsequently withdrawn and was never promulgated as a final regulation, Treasury advised the Service (in connection with TAM 7908005) that the position stated in the withdrawn proposed regulation continued to represent Treasury's policy. (A copy of Treasury's memorandum is attached.) To our knowledge, there has been no subsequent change in this policy, and aside from TAM 7908005, we have been unable to find any revenue ruling or private ruling addressing the treatment of the separation processes for purposes of percentage depletion.

In light of the policy reflected in TAM 7908005 (and Treasury's memorandum), we believe that petitioner's proposed stipulation that its separation, [REDACTED] stabilization and


absorption processes are production processes for percentage depletion purposes is consistent with the Service's administrative practice.¹⁷ Moreover, the separation of [REDACTED] from the [REDACTED] is clearly distinct from the [REDACTED] process, which further processes the separated [REDACTED] to produce elemental [REDACTED]. Thus, we believe that the proposed stipulation would not conflict with the argument that the [REDACTED] process is not a [REDACTED] process.

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Please contact the undersigned at FTS 566-3308 or Jerry Fleming at FTS 566-3345 if there are any questions.

MARLENE GROSS
Assistant Chief Counsel
(Tax Litigation)

By:


PATRICK PUTZI
Special Counsel
(Natural Resources)
Tax Litigation Division

Attachments:

Memorandum dated 1-15-91
Memorandum dated 7-31-78
33 Fed. Reg. 14707-09

¹⁷ Unless petitioner's [REDACTED] stabilization process involves the separation of [REDACTED] from [REDACTED] the treatment of [REDACTED] stabilization as a production process may not be relevant to the issue in this case.